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Title of Document: Cost Principles for Grants and Contracts with Community Providers

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I. PURPOSE

This directive establishes principles for determining costs of grants, contracts and other agreements between the South Carolina Department of Mental Retardation ("SCDMR") and mental retardation boards and other community service providers ("providers"). The principles are designed to provide that the state and federal governments bear their fair shares of costs except where restricted or prohibited by law. The principles do not attempt to prescribe the extent of funding for grants, contracts, or other agreements. Provision for profit or other increment above cost is outside the scope of this directive.

II. APPLICABILITY

These principles shall be used in determining the costs of work performed by community providers under grants and contracts issued by the South Carolina Department of Mental Retardation. All of these instruments are hereafter referred to as "awards."

III. GENERAL PRINCIPLES

A. Basic Considerations

1. Composition of Total Cost. The total cost of an award is the sum of the allowable direct and allocable indirect costs less any applicable credits. Applicable credits would include cost reductions such as purchase discounts, rebates or allowances, insurance recoveries, and adjustments of overpayments

2. Allowable Costs To be allowable under an award, costs must meet the following general criteria:

   a. Be reasonable for the performance of the award and be allocable thereto under these principles.

   b. Conform to any limitations or exclusions in the award or as stated in Appendix 1.

   c. Be consistent with policies and procedures that apply uniformly to both state and federally financed and other activities of the organization.

d. Be accorded consistent treatment.

e. Be determined in accordance with generally accepted accounting principles.

f. Be adequately documented.

g. In the case of Medicaid (Title XIX, Social Security Act) funded programs, be consistent with applicable federal regulations and guidelines set forth in the Health Care Financing Administration's Provider Reimbursement Manual and the South Carolina State Medicaid Plan. For management contracts with SCDMR, the federal regulations for Intermediate Care Facilities for the Mentally Retarded shall take precedence over the State Medicaid Plan, as interpreted by SCDMR. SCDMR will provide pertinent sections of these documents to providers.

3. Reasonable Costs A cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost. Reasonable costs would be those required to be incurred by standards set by SCDMR and program requirements established by the federal government for Medicaid-funded programs, as interpreted by SCDMR and the South Carolina Department of Health and Environmental Control (DHEC). In determining the reasonableness of a given cost, consideration shall be given to:

   a. Whether the cost is of a type recognized in standards, regulations, and other guidelines as ordinary and necessary for the operation of the organization or the performance of the award.

   b. The restraints or requirements imposed by such factors as generally accepted sound business practices, arms length bargaining, federal and state laws and regulations, and terms and conditions of the award.

   c. Whether the individuals concerned acted with prudence in the circumstances, considering their responsibilities to the organization, its members, employees, and clients, the public at large, and the government.

   d. Significant deviations from the established practices of the organization which may unjustifiably increase the award costs.

4. Allocable Costs

   a. A cost is allocable, or assignable to an award in accordance with the relative benefits received. A cost is allocable to a SCDMR award if it is treated consistently with other costs incurred for the same purpose in like circumstances and if it:

(1) Is incurred specifically for the award.

<u>or</u>

(2) Benefits both the award and other work and can be distributed in reasonable proportion to the benefits received.

<u>or</u>

(3) Is necessary to the overall operation of the organization, although a direct relationship to any particular award cannot be shown.

b. Any cost allocable to a particular award or other cost objective under these principles may not be shifted to other SCDMR awards to overcome funding deficiencies, or to avoid restrictions imposed by law or by the terms of the award.

B. <u>Direct Costs</u>

1. Direct costs are costs that can be identified specifically with a particular award.

2. Any direct cost of a minor amount may be treated as an indirect cost for reasons of practicality where the accounting treatment for such cost is consistently applied to all final cost objectives. For these minor cost areas, the accounting effort in charging costs directly is not commensurate to the results achieved.

C. <u>Indirect Costs</u>

1. Indirect (overhead) costs are those that have been incurred for common or joint objectives and cannot be readily identified with a particular award or other final cost objective. Direct costs of minor amounts may be treated as indirect costs under the conditions described in paragraph B.2. above. After direct costs have been determined and assigned directly to awards or other work as appropriate, indirect costs are those remaining to be allocated to benefiting awards. A cost may not be allocated to an award as an indirect cost if any other cost incurred for the same purpose, in like circumstances, has been assigned to an award as a direct cost.

2. Because of the diverse characteristics and accounting practices of provider organizations, it is not possible to specify the types of costs which may be classified as indirect costs in all situations. However, typical examples of indirect costs for provider organizations may include the costs of operating and maintaining shared facilities and general administrative costs for executive directors, financial officers, and shared secretarial staff, including salaries, fringe benefits, and support costs.

IV. COST ALLOCATION PROCEDURES

A. Definitions

1. Cost Allocation Plan

A cost allocation plan is a document explaining the system used by a provider to measure and assign costs to awards and other cost objectives. Where indirect costs are distributed among two or more programs, the plan must explain methodology used to distribute these costs.

2. Cost Center

A cost center is a separate accounting unit to which costs are charged for an organization. A cost center may be established for each award or for each indirect cost center which needs to be allocated. A final cost center is one established for an award; the costs charged there are not further charged or allocated. An intermediate cost center is an accounting unit whose costs are further allocated to other cost centers. For example, if operational and maintenance costs for a shared building are to be allocated or charged out, the separate cost center established for these costs is known as "intermediate."

B. Plan Preparation Requirements

Each provider applying for an award from SCDMR shall submit, as part of the annual budget package, a cost allocation plan based on the proposed budget for the upcoming budget period. The most current actual expenditure and other data should be used to develop as realistic a plan as possible. The plan must include adequate narrative and schedules to explain the methodology used to distribute shared costs. The plan also must include a detailed budget for all shared costs that are allocated.

Providers are required to review the plan during the fiscal year and to make changes, as circumstances change. Cost allocation plans must be re-submitted to SCDMR when significant changes occur during the year. Significant changes would include receipt of a new award from SCDMR or an amendment to an existing contract that would increase or decrease the provider's total funding by five percent or more.

At the end of the fiscal year, a final cost allocation should be prepared. This will permit adjustments to the books as the auditors complete the audit for the year.

C. Allocation Methods

1. Simplified Allocation Method

a. Applicability: Where a provider does not operate Medicaid-funded programs, the simplified allocation method may be used.

b. Procedure for Charging Joint Costs: Under this method all costs of the organization are treated as direct costs with the exception of general administrative costs. Joint, shared costs such as rental costs, operation and maintenance of facilities, and telephone costs are prorated individually as direct costs to each award using the base most appropriate to the particular cost being prorated. Example allocation bases are listed in Appendix 2.

c. Treatment of Indirect Costs: Under the simplified method indirect costs include only general administrative costs including costs of the executive director's office, accounting and clerical services, audit costs, and other costs not readily assignable to awards. These indirect costs are allocated to awards on the basis of total direct costs of the awards.

d. Plan Preparation Steps: The following steps should be followed in preparing a cost allocation plan using the simplified method:

   (1) Establish clearly definable cost centers with the advice of auditors.

   (2) Identify cost centers as either final or intermediate. Final cost centers are client service programs, usually with separate contracts or grants. Charges to intermediate cost centers (for example, administration) must be further spread through the cost allocation plan.

   (3) Estimate the total annual costs for all cost centers, based on prior year actual figures or the current year budget. For contracts based on standardized award amounts, direct program costs, not DMR-established payment levels, should be used for the purpose of cost allocation.

   (4) Determine the most reasonable allocation basis for each intermediate cost center. The bases chosen should closely reflect benefits received from service areas and also be feasible in terms of data collection. For allocating administrative and general management costs, including costs of MR board executive director offices, total direct costs should generally be used. A list of possible allocation bases is attached as Appendix 2.

   (5) Allocate all intermediate cost centers to all final cost centers that they benefit.

   (6) Total the costs for all final cost centers. The totals represent the estimated full costs of operating the service programs.

2. Step-Down Allocation Method

a. Applicability. Where a provider operates Medicaid-funded facilities, the step down allocation method must be used. Providers without Medicaid-funded programs may use this method if it will make a significant difference in the allocation of indirect costs.

b. Overview of Plan Preparation. Under this method of plan preparation, joint, shared costs are pooled in intermediate cost centers. A separate intermediate cost center should be established for each cost area to be separately allocated. Typical intermediate cost centers for mental retardation boards include, but are not limited to, the following: administration; transportation; facility costs, including rent, utilities, and maintenance; and day program costs, where the day program serves the residential facilities funded by Medicaid. Each intermediate cost center is to be allocated to all other benefiting cost centers, whether they be final or intermediate. Three basic rules govern the allocation process:

- • Allocate first cost centers benefiting the greatest number of other cost centers.
- • A cost center should not be allocated back to itself.
- • Once an intermediate cost center is allocated, it should receive no further allocations.

c. <u>Plan Preparation Steps:</u> The following steps should be followed in preparing a cost allocation plan using the step-down method:

(1) Establish clearly definable cost centers with the advice of auditors.

(2) Identify cost centers as either final or intermediate. Final cost centers are client service programs, usually with separate contracts. Charges to intermediate cost centers must be further spread through the cost allocation plan.

(3) Estimate the total annual costs for all cost centers, based on prior year actual figures or the current year budget. For contracts based on standardized award amounts, direct program costs, not DMR-established payment levels, should be used for the purpose of cost allocation.

(4) Determine the order in which the intermediate cost centers should be allocated. Those centers that benefit the greatest number of other cost centers should generally be allocated first.

(5) Determine the most reasonable allocation basis for each intermediate cost center. The bases chosen should closely reflect benefits received from service areas and also be feasible in terms of data collection. For allocating administrative and general management costs ("home office"

costs), total direct costs must be used for Medicaid purposes when the organization provides a variety of services in addition to residential programs. A list of possible allocation bases is attached as Appendix 2.

(6) Begin with the first intermediate cost center and allocate its cost to all other cost centers, including intermediate and final. The costs of the cost center should not be allocated back to itself.

(7) Allocate, in succession, each of the other intermediate cost centers to all other cost centers except for centers that have already been allocated. Each cost center allocated is "closed out" and receives no further allocations. Continue the process until the costs of all intermediate cost centers are allocated to final cost centers.

(8) Total the costs for all final cost centers. The totals represent the estimated full costs of operating the service programs.

Deputy Commissioner, Fiscal Affairs (Originator)	Commissioner (Approved)

Please view the Appendix below:

Appendix

LIMITATIONS ON COSTS FOR AWARDS WITH THE

SOUTH CAROLINA DEPARTMENT OF MENTAL RETARDATION

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The following cost limitations shall apply to community program awards of the SCDMR.

(1) Compensation for non-working provider officers - Disbursement of funds or other assets to an agency officer who has not performed in a work capacity are not allowable costs. (This does not preclude transportation and other travel expenses related to attending agency board meetings and other agency-related business from being reimbursed.)

(2) Entertainment - The cost of non-client entertainment is not allowable for charges to SCDMR awards.

(3) Transportation - Transportation expenses to be reimbursable from grant funds must be either directly related to the provision of services for the recipient or integral to the operation of the program, provided they are not reimbursed from some other source. The expense of agency-owned automotive equipment by staff for personal business or non-work related transportation is not reimbursable from award funds.

(4) Bad debts - Bad debts are not an allowable cost item from award funds. Bad debts should be treated as a deduction from income.

(5) Donations - Donations or contributions are not allowable cost items from award funds. "Donations" are defined as a gift of cash or in-kind services to other organizations and persons external to the program activities funded through the award. This exclusion does not apply to funds paid to other organizations as part of contracts for specific services.

(6) Non-client meals - Non-client meals are not allowable costs for award funds. "Non-client meals" are defined as meals consumed by parents, guests and staff when staff attendance with the client is not programmatically mandatory.

(7) Interest - Interest cost on borrowed funds which are required to provide program services to clients, or reasonably related to client services, is reimbursable from grant award funds. The following items of interest cost are not reimbursable by award funds:

A) Funds borrowed for investment purposes;

B) Funds borrowed to create working capital in excess of three months' operating costs;

C) Funds borrowed for the personal benefit of employees, officers, board members of the agency;

D) Funds borrowed without a prior, written approval of SCDMR for the purpose of land, buildings, and/or equipment for future expansion;

E) Interest in excess of the prime interest by the provider to persons or organizations who are related to the provider through control, ownership, or family relations;

F) Interest paid to related persons or organizations as defined in 9(C) of this Appendix.

(8) Intra-provider fund loan interest charges - Interest costs for intra-provider loans among funds are not a reimbursable cost from award funds. A provider is defined as an organizational entity with a single Federal Employer's Identification Number.

(9) Rentals

A) Rental income - Any rental income received by a provider must be used to reduce the reimbursable cost by award funds for the item rented, provided the cost item is allowable.

B) Rental costs of buildings and equipment - Rental costs for buildings and equipment which are reasonable in relation to the local market for these items and which are necessary to provide program services to clients or reasonably related to client care are reimbursable expenses. Any lease payments made to any organization for facility rental is treated as a third-party transaction, and allowable cost equals the actual lease costs or the fair rental value for similar properties in the area, whichever is less.

C) Costs resulting from transactions with related persons or organizations will be considered as a part of the provider's allowable costs to the extent that the purchases represent the actual cost to the related persons or organizations. For example, an agency may rent a building from a related organization or person. The costs recognized for reimbursement purposes are the actual costs to the related person or organization (such as depreciation, interest on mortgage, real estate taxes, insurance, and other program approved expenses) rather than the rental amount paid by the provider to the related person or organization. Thus, the net effect is to treat the rented facility as though it were owned by the agency.

D) The following definitions will be applied in determination of existence of common ownership or control between the provider and the supplying person or organizations:

i) Relatives of the provider staff or of those who have control or common ownership include husband, wife, natural parent, child, sibling, adopted child, adoptive parent, stepparent, stepchild, stepbrother, stepsister, father-in-law, mother-in-law, daughter-in-law, son-in-law, brother-in-law, sister-in-law, grandparent, and grandchild.

ii) Related to the provider or those who have control or common ownership means that to a significant extent there exists on the part of the provider providing care an association with the person or organization furnishing the service, resources, facilities, or supplies.

iii) Control exists when a person or organization has the power, directly or indirectly, to influence or direct the actions or policies of a provider or the provider's funded program.

iv) Common ownership exists when a person or persons possess part or full ownership or equity in the agency being funded and the person or organization servicing the agency.

v) The above definitions shall be applied as a rule in the determination as whether there exists common ownership or control between the provider and the supplying person or organization. This rule applies whether the providing person or organization is a sole proprietorship, partnership, corporation, trust or estate or any other form of business organization, proprietary or nonprofit.

(10) Sales of goods or services - For funded sheltered workshops or work activity programs, the cost of recipient wages and material acquisition is not allowable from award funds when the product or service produced by the recipient is marketable and when the revenue covers costs. Any costs incurred by the provider for the sale of goods or services are not reimbursable from award funds to the extent the costs are covered by revenue.

(11) Fund raising - Costs associated with fund raising are not allowable for awards. These costs should be paid from the proceeds of the fund raising activities.

(12) Reserve funds - Providers may establish reserves of fund balances for specific future capital outlays such as major repairs and replacement of buildings and vehicles. Capital outlays are expenditures that result in the acquisition of or addition to fixed assets, which are assets of a long-term nature. If a reserve fund is established by a governing board, restrictions must be developed to avoid transferring monies out of the fund to cover recurring operating expenditures. Providers may consider computing the amount to transfer into the reserve funds on the basis of depreciation or projected replacement cost of the assets.

SAMPLE ALLOCATION BASES

FOR SHARED COST AREAS

	Suggested Bases
Administration/Executive Director's Office	Total Direct Costs plus an Allocation of Capital Costs Including Interest and Depreciation*
Facility Costs, Including Rent, Utilities, Maintenance, Insurance	Square Footage
Financial	Management Total Direct Costs or Number of Transactions
Personnel/Payroll	Number of Employees
Telephone	Number of Instruments
Transportation of Clients	Client Miles or Vehicle Miles

* Required allocation basis for Medicaid; capital costs would normally be allocated on the basis of square footage.